Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Morrow	Analyst:	Jane Tolman	Bill Number:	SB 622
Related Bills:	See Legislative History	Telephone:	845-6111	Introduced Date:	02-20-2003
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: NOL Deduction Allowed To San Diego County Agriculture Business For Loss Attributable To Mexican Fruit Fly Quarantine

SUMMARY

This bill would allow special net operating loss (NOL) treatment for losses sustained as a result of the Mexican fruit fly quarantine in San Diego County.

This analysis will not address the provisions related to the emergency plan for agricultural related disasters, as they do not impact the department.

PURPOSE OF THE BILL

The author's staff has indicated that the purpose of this bill, among other things, is to allow tax relief to those affected by the Mexican fruit fly infestation.

EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2004.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

An NOL is defined as the excess of allowable deductions (as specifically modified) over gross income. Federal law provides, in general, that an NOL can be carried back two years and forward 20 years. Special rules are provided for the carryback of NOLs arising from specified liability losses, excess interest losses, casualty or theft losses, disaster losses, or small business and farming losses.

Existing state law conforms to the federal computation of an NOL. However, California does not allow NOL carrybacks. Depending on the type of taxpayer or amount of taxpayer's income, the amount of the NOL that is eligible to be carried forward and the numbers of years it can be carried forward will vary.

The taxpayer must make an irrevocable election as to the type of NOL that will cover the NOL the taxpayer has incurred.

Board Position:			Department Director	Date
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LSB TEMPLATE (rev. 6-98)

For most taxpayers, the computed NOL may be carried forward for 10 years as follows:

- For taxable years beginning on or after January 1, 2000, and before January 1, 2002, 55% of the NOL may be carried forward.
- For taxable years beginning on or after January 1, 2002, and before January 1, 2004, 60% of the NOL may be carried forward.
- For taxable years beginning on or after January 1, 2004, 100% of the NOL may be carried forward.
- The election to compute the NOL must be made in a statement attached to the original return and is irrevocable, and applies to both federal and state elections.

Under existing state law, the special LAMBRA NOL and the enterprise zone NOL are allowed a 15-year carryforward period.

For taxable years beginning on or after January 1, 2001, and before January 1, 2003, farmers were allowed an NOL deduction for losses sustained due to Pierce's disease and its vectors in California. To claim these NOLs the California Department of Food and Agriculture (CDFA) must determine that a particular pest infestation (Pierce's disease) caused the NOL.

Under existing state and federal law, taxpayers engaged in the business of farming are allowed to deduct the expenses related to planting and growing crops as an ordinary and necessary business expense. Farm losses may be deducted as an ordinary loss, limited to the taxpayer's farm income, in the taxable year sustained. Losses are deductible to the extent not compensated for by insurance or otherwise.

All deductions for NOLs for the 2002 and 2003 taxable years have been suspended. However, taxpayers may generate an NOL during the suspension period that may be applied when the suspension expires. The carryover periods for suspended NOLs are extended by one or two years, depending on whether the NOL was incurred in 2002 or 2003. When the suspension expires, taxpayers may thereafter carry forward newly incurred NOLs (in taxable years beginning on or after January 1, 2004) at the rate of 100%.

THIS BILL

This bill would allow an agriculture related trade or business special NOL treatment for losses attributable to the Mexican Fruit Fly quarantine that are not covered by insurance. The special NOL would be limited to losses incurred in San Diego County in taxable years beginning on or after January 1, 2003. This means NOLs may be deducted against a taxpayer's taxable or net income on or after January 1, 2003. The special NOL treatment under this bill would allow 100% of the NOL to be carried forward for 15 taxable years.

IMPLEMENTATION CONSIDERATIONS

The department has identified the implementation concerns listed below. Department staff is available to work the author's office to resolve these and other concerns that may be identified.

- Without reference to either the existing state NOL statute or the Internal Revenue Code, it is not clear how the special NOL would be calculated. This could result in disputes between the taxpayers and the department.

- The bill allows a 15-year carryover for 100% of a net operating loss "not covered by insurance." While insurance is available for specified risks or property, the availability of insurance determines the amount of a loss deduction. Normally insurance has no direct impact on an NOL because an operating loss is not a typical insured risk.

- This bill uses an undefined term "agriculture related trade or business." As a result, this bill may benefit trades or businesses that the author did not intend. For example, machinery companies, office supply companies, automobile dealerships, and other businesses that support the agricultural industry impacted by the Mexican fruit fly would arguably qualify for special NOL treatment under this bill.

Once the implementation considerations are resolved, this bill would not significantly impact the department's programs and operations.

<u>TECHNICAL CONSIDERATION</u>

Current law states that taxpayers that elect to take any NOL other than a general NOL are required to make an irrevocable election. This bill does not require the taxpayer to make an irrevocable election. As a result, the taxpayer could claim the special NOL and the general NOL for the same losses.

LEGISLATIVE HISTORY

AB 2170 (Rod Pacheco, 1999/2000) would have allowed special NOL treatment for losses sustained by a farmer as a result of pest infestations. This bill failed passage in the Assembly Appropriations Committee.

AB 2435 (Thompson, 1999/2000) would have allowed taxpayers a 100% credit equal to the grape crop losses sustained by a grapevine grower because of the Glassy-Winged Sharpshooter pest or Pierce's Disease. This bill failed to pass the Assembly Committee on Agriculture.

AB 238 (Pacheco, Ch. 623, Stats. 2001) allows a special NOL treatment for losses sustained by farmers as a result of pest infestations.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan*, and *Minnesota*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. The states surveyed follow the IRS regulation regarding NOL's and do not provide special treatment for agricultural related losses.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

San Diego County agricultural experts indicated that according to a survey of farmers the loss due to Mexican Fruit Fly quarantine could reach $13 million for 2003. This is an upper limit under the assumption that no infected crops would be marketed. To the extent that some of the crops would be marketed, the total loss would be less than $13 million. It was assumed that $3 million of the crops would be marketed. It was further assumed that 20% of the farmers have insurance. As a result, it was assumed there would be an $8 million NOL.

Starting with the $8 million NOL in 2003, under current law 60% of this ($4,800,000) would be carried over to 2004. Assuming that only 40% of this carryover will be used, leaves a carryover of $1,920,000. Using a tax rate of 8% the tax effect would equal $153,000.

Under the proposed law, 100% of that $8 million NOL would be carried over, and it is assumed that only 40% of this carried over amount would be used. This leaves a carryover of $3,200,000 with a tax effect at 8% of $256,000.

The difference between the current law and the proposed law is $102,400 that has been rounded down to $100,000. This bill would only affect 2003 operating losses.

Revenue Impact of SB 622
Operating Losses for the 2003 Tax Year
Enactment Assumed after June 30, 2003

	Current Law	**Proposed Law**
San Diego Loss in 2003	$8,000,000	$8,000,000
Carryover %	60%	100%
Carryover amount	$4,800,000	$8,000,000
% Usable in 2004	40%	40%
Amount usable in 2004	$1,920,000	$3,200,000
Tax Impact @ 8%	$153,600	$256,000
Difference (revenue impact) ==>		**$102,400**

POLICY CONCERN

This bill would exclude taxpayers impacted by the Mexican fruit fly in areas other than San Diego County. As a result, this bill may be interpreted to provide preferential treatment.

LEGISLATIVE STAFF CONTACT

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